QUESTIONS PRESENTED

1. Did the Ninth Circuit correctly hold that payments of interest and loan charges made by *ZZZZ* Best Co., Inc. to Union Bank during the ninety day period prior to the filing of its Chapter 11 Petition on account of an eight and one-half month revolving line of credit extended by Petitioner to *ZZZZ* Best Co., Inc., constituted a voidable preference on a long-term loan, thereby excluding it from protection under 11 U.S.C. § 547(c)(2)?

If the Court concludes that 11 U.S.C. § 547(c)(2) protects the payment made by *ZZZZ* Best Co., Inc., to Union Bank on account of the long-term revolving line of credit loan obligation, then the following additional question is presented for determination:

2. Did the Ninth Circuit err by failing to find that *ZZZZ* Best Co., Inc. was engaged in a Ponzi scheme and, therefore, that the ordinary course of business exception found in 11 U.S.C. § 547(c)(2) does not protect the payments made to Union Bank?

LIST OF PARTIES

The parties to the proceedings below were the Petitioner, Union Bank, and the Respondent, Herbert Wolas, in his capacity as the Chapter 7 Trustee for the bankruptcy estate of ZZZZ Best Co., Inc.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 90-1491

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF ON THE MERITS BY RESPONDENT

Herbert Wolas, the Respondent herein, prays that the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on December 28, 1990, be affirmed.

OPINIONS BELOW

The December 28, 1990 opinion of the Court of Appeals for the Ninth Circuit reverses the judgments of the district and bankruptcy courts. The opinion is reported at 921 F.2d 968 and reprinted as Appendix A to the Petition for Writ of Certiorari filed by Petitioner, at 1a.

On August 8, 1989, the District Court for the Central District of California (the "District Court") entered its Order Affirming Judgment, affirming the summary judgment of the bankruptcy court granted in favor of the Petitioner, Union Bank. The District Court order was appealed by the Respondent to the Court of Appeals for the Ninth Circuit. The District Court order was not published and is reprinted as Appendix B to the Petition for Writ of Certiorari filed by Petitioner, at 3a.

The order of the Bankruptcy Court for the Central District of California (the "Bankruptcy Court") granting summary judgment in favor of the Petitioner, from which appeal was taken by the Respondent to the District Court, was not published. The Bankruptcy Court's Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief, entered August 23, 1988, and Findings of Fact and Conclusions of Law related thereto, are reprinted in Appendices C and D to the Petition for Writ of Certiorari filed by Petitioner at 6a and 10a, respectively.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit in favor of Respondent was entered on December 28, 1990, reversing the judgments in favor of the Petitioner entered by the District Court and the Bankruptcy Court. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1). On May 13, 1991, this Court granted Petitioner's Petition for Writ of Certiorari.

STATUTES INVOLVED

The statute involved is 11 U.S.C. § 547(c)(2) which is set forth in Petitioner's Brief.

STATEMENT OF THE CASE

On November 25, 1987, the Trustee filed a Complaint against the Petitioner, Union Bank, alleging the receipt of preferential payments made to it by ZZZZ Best Co.,

Inc. ("ZBest") within 90 days prior to the date ZBest filed for relief under Chapter 11 of the United States Bankruptcy Code. On or about May 10, 1988, Union Bank brought its Motion for Summary Judgment and on May 23, 1988, the Trustee filed his Cross-Motion for Summary Judgment. On August 23, 1988, the Bankruptcy Court entered summary judgment in favor of Union Bank and against the Trustee and denied the Trustee's Cross-Motion for Summary Judgment.

The Trustee then filed his Notice of Appeal on August 29, 1988. After Union Bank objected to the jurisdiction of the Bankruptcy Appellate Panel for the Ninth Circuit, this case was referred to the District Court.

On August 8, 1989, the District Court, the Honorable David V. Kenyon presiding, affirmed the Order of the Bankruptcy Court granting summary judgment against the Trustee and in favor of Union Bank. The Trustee timely appealed to the United States Court of Appeals for the Ninth Circuit.

The events giving rise to the making of the preferential payments by ZBest to Union Bank are relatively simple. Essentially, on or about December 14, 1986, ZBest and Union Bank entered into a Revolving Credit Agreement whereby Union Bank agreed to loan ZBest the sum of $7 million. ZBest borrowed the entire $7 million credit facility on December 17, 1986.

To evidence the takedown of the funds, a commercial promissory note (the "Promissory Note") in the amount of $7 Million was executed on December 17, 1986. The Promissory Note stated a maturity date of August 31, 1987. In addition, the Promissory Note required the payment of interest at the rate of not less than $500.00 per month or 0.650% per year in excess of Union Bank's reference rate, whichever was greater on the outstanding principal loan amount.

The alleged business operation of ZBest with respect to its restoration contracts (which constituted substantially all of ZBest's alleged gross receipts) was a fraud since the alleged restoration contracts never existed and were entirely fictitious. The continuous borrowing and repayment of funds by ZBest from investors and creditors during its fraudulent operation and prior to its filing for relief under Chapter 11 was tantamount to a fraudulent scheme designed to induce investors and/or creditors to extend credit and to repay certain investors and/or creditor in order to induce said persons to further extend larger sums of credit. In essence, the operation of ZBest, as carried out by its officers and directors, was tantamount to the classic "Ponzi" scheme. The end result of the Ponzi scheme was the dissipation of all funds provided by investors and/or creditors to areas and/or persons unknown, with a total resulting loss to investors acquiring shares of stock in ZBest and large losses to creditors who extended credit.

After the Bankruptcy Court and District Court found for Petitioner, the Respondent Trustee appealed the District Court's ruling to the Court of Appeals for the Ninth Circuit.[1] A three-judge panel of the Ninth Circuit reversed in a *per curiam* opinion, relying on the decision of another panel of the court in *CHG International, Inc. v. Barclays Bank (Matter of CHG International, Inc.)*, 897 F.2d 1479 (9th Cir. 1990).

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[1] The Ninth Circuit's jurisdiction to hear the appeal was provided by 28 U.S.C. § 158(d) which grants the circuit courts of appeals jurisdiction to hear appeals from final decisions of the district courts entered pursuant to 28 U.S.C. § 158(a) and (b).

SUMMARY OF ARGUMENT BY RESPONDENT

In *ZBest*, the Ninth Circuit held that interest payments made on account of a *long-term debt do not qualify* for the protection of the "ordinary course of business" exception of § 547(c)(2) *as a matter of law*. Furthermore, the Ninth Circuit's *Zbest* decision held that the eight and one-half-month revolving line of credit constitutes "long-term" debt for the purposes of § 547(c)(2) because one of the two debts in the prior Ninth Circuit decision in *CHG International* case had a term of seven months and was held to be long-term debt.

For the reasons hereinafter set forth, Respondent contends that as a matter of law, the Ninth Circuit correctly determined that the revolving line of credit constituted a long-term debt obligation of ZBest and that payments made on account of such indebtedness are not to be afforded protection under the provisions of § 547(c)(2). Specifically, the Petitioner would have this Court emasculate a long line of judicial and statutory protection provided to a debtor and creditors of the debtor's estate by having this Court determine the intent of Congress to do away with all long-standing rules regarding recovery of preference payments on long-term debt obligations to a lender. The Ninth Circuit *correctly* determined that the applicable exception to recovery of a preference by a trustee for the benefit of the creditors of an estate should only extend to short-term trade credit obligations and that the preference provisions should not be a rule swallowed up by exceptions. The Ninth Circuit *correctly* concluded that the 1984 amendment to the statute by Congress was not intended to extricate all transfers on account of antecedent debts; rather, it was intended to provide assurances to trade creditors who continued to provide value to a debtor that payments received during a preference period would not be subject to attack by a trustee so long as value was equally exchanged. More importantly, the scant legislative his-

tory, coupled with the fact that Congress only eliminated an artificial time limitation under § 547(c)(2), further supports the Ninth Circuit's analysis and conclusions.

In the case at bar, the value of all funds received by ZBest from Petitioner were dissipated by it during its operation of a fraudulent business activity. The continued perpetuation of the fraudulent activity was the direct result of ZBest maintaining the status quo on its long-term debt obligations to Petitioner to avert the Petitioner seeking legal redress which may have resulted in an earlier collapse of ZBest's fraudulent business operation. Specifically, the ZBest operation was not a legitimate business operation and, as the Bankruptcy Court noted, may not have been sufficient to constitute a going concern such that the debt obligation incurred by it to Petitioner was incurred in its ordinary course of business inasmuch as ZBest may not have had an ordinary course of business.

The Petitioner is quick to point out that the Ninth Circuit did not define what constitutes "long-term" debt. Petitioner's Brief on the Merits ("Petitioner's Brief") at p. 20. However, this is not an appropriate statement. The Ninth Circuit defined what is not short-term debt and, specifically determined that an eight and one-half-month revolving line of credit was tantamount to a long-trem debt obligation.

The Ninth Circuit Court of Appeals *correctly* determined that the revolving line of credit constituted a long-term debt obligation and, therefore, as a result thereof, the payments made by ZBest to Petitioner, Union Bank, were not within the ordinary course of business exception to the transfers which are otherwise preferential. In so holding, the Ninth Circuit determined that the plain Congressional intent of the statute was merely to remove an artificial time period for determining the date upon which a debt is incurred and in connection therewith, to focus attention upon the benefit to the estate of

the debtor through the value received in exchange for payments made.

It is clear that the Congressional modification to § 547(c)(2) was not intended to overrule a long line of statutory and judicial history since *no* such meaning can be gleaned from the Congressional reports. Rather, what is clear is that the Congress intended to provide protection to trade creditors who continued doing business with a debtor during the debtor's slide into bankruptcy. This intent is more fully set forth at the Notes of Committee on the Judiciary, S. Rep. No. 989, 95th Cong., 2nd Sess. (1978), *infra.*

In making its argument, the Petitioner attempts to have this Court set forth and define a *bright line* test as to what constitutes a long-term debt or a short-term debt obligation. After reaching this determination, Petitioner requests this Court to determine that § 547(c)(2) protects long-term debt and short-term debt. Petitioner makes reference to generally accepted accounting principles but, however, fails to show their relevancy to a bankruptcy situation. See Petitioner's Brief at p. 20. Importantly, it is worth noting that the primary purpose of the preference provisions is to provide *equality* among creditors and to require disgorgement of amounts received by one creditor for its exclusive benefit and to the detriment of other similarly situated creditors. In such settings, it is also important to note that where a creditor provides value in exchange for the payments received, perhaps a debtor's slide into bankruptcy is minimized. Turning to the facts of the case at bar, it becomes evident that the $7 million loan by Petitioner, Union Bank, to ZBest, was not an ordinary transaction. Rather, it was an extraordinary transaction. The funds were provided in December, 1986, seven months prior to the date upon which ZBest filed for protection from creditors. All funds provided by Petitioner, Union Bank, were dissipated by ZBest in its fraudulent business operation. To

that extent, the payments of monthly interest accruals (which Petitioner alleges to be ordinary payments) could not possibly have provided any benefit to the estate other than to merely hold off the Petitioner from seeking to enforce its provisions of default under its loan agreement. Petitioner can point to *no* benefit to ZBest resulting from the preferential payments made allegedly in ZBest's ordinary course of business.

In addition, the Ninth Circuit did not rule upon the issue of whether or not the existence of the ZBest's fraudulent operation eliminates the availability of the ordinary course of business exception to a creditor since one engaging in such an activity cannot be said to be engaging in an "ordinary" business.

This Court should not be asked to rewrite a statute. Respondent opines that statute writing is best left to the legislative branch which, if Petitioner believes does not correctly set forth a predominant test, should be addressed by additional legislation.

ARGUMENTS OF RESPONDENT

I. CONGRESSIONAL AMENDMENTS TO § 547(c)(2) UNDER THE 1984 ACT WERE NOT INTENDED TO PROTECT PAYMENTS ON LONG-TERM DEBT OBLIGATIONS FROM A TRUSTEE'S PREFERENCE AVOIDING POWERS.

As a result of perceived unfairness to trade creditors and issuers of commercial paper through the strict application of § 547, Congress considered numerous bills proposing changes to § 547(c).[2] The end result was the passage of the 1984 amendments. Several specific problems involving trade debt, commercial paper, and consumer debt had been encountered in the application of § 547 and led to two significant changes to the § 547(c)(2)'s requirement that the payment to the creditor be made within forty-five days of the date the debt was incurred.[3] Second, Congress added a new exception, §547

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[2] *See* H.R. 5148, 98th Cong., 2d Sess. (1984); H.R. 1800, 98th Cong., 1st Sess. (1983); S. Rep. No. 445, 98th Cong., 1st Sess. (1983); H.R. 1169, 98th Cong., 1st Sess. (1983); H.R. 1147, 98th Cong., 1st Sess. (1983); H.R. 1085, 98th Cong., 1st Sess. (1983); S. Rep. No. 2000, 97th Cong., 2d Sess. (1982); S. Rep. No. 2000, 97th Cong., 1st Sess. (1981); H.R. 4786, 97th Cong., 1st Sess. (1981); S. Rep. No. 863, 97th Cong., 1st Sess. (1981); H.R. 3705, 97th Cong., 1st Sess. (1981); S. Rep. No. 3259, 96th Cong., 2d Sess. (1980); S. Rep. No. 3023, 96th Cong., 2d Sses. (1980); H.R. 5447, 96th Cong., 1st Sess. (1979); S. Rep. No. 658, 96th Cong., 1st Sess. (1979). Broome, *Payments on Long-Term Debt as Voidable Preference: The Impact of the 1984 Bankruptcy Amendments*, 1987 Duke Law Journal 78 (1987) (hereinafter referred to as "Broome").

Many of the proposals were designed to correct technical problems and unintended consequences of some of the changes made by the 1978 Code. *See, e.g.*, S. Rep. No. 305, 96th Cong., 1st Sess. 2 (1979).

[3] Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333, 378 (1984). Broome, *see supra* note 2, at 100.

(c)(7), for small dollar amount transfers made by consumer debtors.[4]

The complaints made to Congress regarding the elimination of the forty-five day period were lodged primarily by trade creditors, commercial paper issuers, and consumer lenders.[5] Trade creditors complained that many normal trade payments by a business debtor were avoidable, in the absence of the reasonable cause to believe requirement, and were in many instances not saved from preferential avoidance by the forty-five day rule in § 547(c)(2). Significantly, Congress did not hear from long-term business creditors; they did not complain about the operation of the 1978 Code because most long-term business loans are secured.[6]

The most critical factor considered by Congress in eliminating the forty-five day requirement was that, contrary to previous assumptions,[7] the forty-five day period between the date of payment and the date of the incurrence of a debt did not comply with the trade credit practices in most industries. Industry groups argued that they had

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[4] 11 U.S.C. § 547(c)(7) (Supp. III 1985). Broome, *see supra* note 2, at 100.

[5] The hearing testimony before Congress, *see supra* note 2, related to problems experienced by these groups. Broome, *see supra* note 2, at 100.

[6] *See infra* note 25. *See also* Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 Hous. L. Rev. 289, 302 (1980).

J. Pringle & R. Harris, Essentials of Managerial Finance 462 (1984); J. Weston & E. Brigham, Essentials of Managerial Finance 272 (7th ed. 1985). Broome, *see supra* note 2, at 100.

[7] The drafters assumed that the 45-day period between the date of payment and the date of the incurrence of a debt was compatible with the trade credit practices in most industries. *Minutes of the Subcomm. on Civil & Constitutional Rights of the House Comm. on the Judiciary*, 95th Cong., 1st Sess. 553 (1977), Mark-up of Minutes of H.R. 6, at 553. Broome, *see supra* note 2, at 101.

normal payment periods of forty-five days or longer [8] and that trade credit periods exceeding forty-five days were common in many seasonal industries including the clothing, toy, and sporting goods industries.[9] However, these considerations are wholly inapplicable to the extension of long-term credit by a bank since the date of the loan governs the date the debt is incurred and, therefore, reference to a "normal trade cycle" with respect to repayment of a long-term debt obligation by a debtor is irrelevant.

To prevent application of a trustee's preference avoiding powers, many short-term trade creditors constructed normal trade credit periods to fit within the protection of § 547(c)(2).[10] It was thought that this distortion of business practices would have one of two effects. Either trade creditors would be unwilling to extend credit for a period longer than forty-five days, causing severe cash flow problems to the buyers and retailers with whom they dealt [11], or, if credit was extended for longer than forty-five days, the trade creditor would demand terms that would compensate it for the increased risk that any payment it received might be avoided and recovered if the debtor subsequently entered a bankruptcy proceeding.[11]

Section 547(c)(2)'s forty-five day requirement was troublesome even in industries with normal trade credit terms of less than forty-five days because debtors encountered considerable difficulty in determining when the

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[8] *See 1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 259.

[9] *Id.* at 254 (statement of Irving Sulmeyer, attorney).

[10] *See 1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 248. Fortgang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. Rev. 1148 (1981).

[11] *See 1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 255. Broome, *see supra* note 2, at 101.

[12] *See id.* at 198.

debt was deemed to be incurred [13] and when the payment was deemed to be made.[14] Court decisions demonstrated that the technical application of the forty-five day requirement left payments made to many trade creditors unprotected from avoidance.[15]

Short-term creditors, other than those extending trade credit, also encountered difficulties with the operation of § 547(c)(2). Commercial paper issuers objected to the effect § 547(c)(2) had on the market for commercial paper [16], a short-term, unsecured debt obligation typically issued by large corporations.[17] Absent the "reasonable cause to believe" requirement, if a commercial paper issuer entered a bankruptcy proceeding within ninety days after repaying a purchaser, the payment would be a preferential transfer and the purchaser might be required to remit the payment as an avoidable preference.[18]

[13] The determination of the date on which the debt is incurred has proved difficult for many courts. *See, e.g.*, Nolden v. Van Dyke Seed Co. (*In re Gold Coast Seed Co.*), 751 F.2d 1118, 1119 (9th Cir. 1985).

Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Code*, 17 U. Rich. L. Rev. 667, 681 (1983).

[14] *See* Herbert, *supra* note 13, at 689.

[15] *See, e.g.*, Grogan v. Liberty National Life Insurance Co. (*In re* Advance Glove Manufacturing Co.), 761 F.2d 249, 252 (6th Cir. 1985) (payments for insurance premiums avoided because not made within 45 days of due date).

[16] *See Hearings on S. Rep. No. 3023, supra* note 2, at 8-17.

[17] A purchaser, often an institutional investor, buys the issuer's commercial paper for cash in return for the issuer's promise to repay the cash, plus interest, at a fixed time in the future. Commercial paper is necessarily a short-term debt; maturities of commercial paper issues are limited to less than 270 days to avoid registration with the Securities and Exchange Commission. *See Hearings on S. Rep. No. 3023, supra* note 2, at 13.

[18] *Hearings on S. 3023, supra* note 2, at 14.

The only way a purchaser could be assured that the payment would not be avoided was to purchase commercial paper with a maturity of less than forty-five days. The result under the 1978 Bankruptcy Code was an artificial shortening of the maturities of commercial paper from as much as 270 days to less than forty-five days" and a decrease in access to the commercial paper market for companies that did not want to issue commercial paper for such a short term.[20]

A further problem noted during this period was the avoidance of preferential payments made by consumer debtors. Section 547(c)(2) excepted a payment by a consumer debtor from avoidance only if the payment was made and the debt was incurred in the "ordinary course of . . . financial affairs of the debtor and the transferee," and the payment was made according to ordinary business terms, and within forty-five days of the date the debt was incurred.[21] Creditors complained that regular payments received from consumer debtors on long-term installment obligations were avoidable even though the creditors may not have had reasonable cause to believe that the debtor was insolvent. Some creditors receiving payments from consumer debtors on long-term installment obligations attempted to assert entitlement to § 547(c)(2)'s protection by arguing that the date the debt was "incurred," i.e., the date the forty-five day period began to run, was the date the loan payment was due. The United States Court of Appeals for the Seventh Circuit rejected this argument

[19] *See Hearings on S. 3023, supra* note 2, at 14. *See also* Fortgang & King, *supra* note 10, at 1170 ("[Section 547(c)(2)] functions to require a period of maturity that in many instances may be unrealistic."). Broome, *supra* note 2, at 104.

[20] *See Hearings on S. Rep. No. 3023, supra* note 2, at 15.

[21] 11 U.S.C. § 547(c)(2) (1982), *amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333, 378.

in *Barash v. Public Finance Corp.*[22] and held that regular installment payments by consumer debtors to undersecured creditors were avoidable as preferences because the debt for the principal amount of the loan was incurred on the date of the loan, rather than on the date each installment was due.[23] Most courts[24] and legal commentators[25] agree with this result.

Following the holding in *Barash* that a consumer debt was incurred when the loan funds were advanced, creditors next took up the argument that payments made by business debtors for the interest portion of a long-term debt were protected by the forty-five day exception because the debt for interest was incurred each day as the

[22] 658 F.2d 504 (7th Cir. 1981). *See also, Energy Cooperative, Inc. v. Socap International, Ltd.*, 832 F.2d 997, at 1004 (7th Cir. 1987) in which the Seventh Circuit Court citing *Barash* again found that § 547(c)(2) "protects 'ordinary trade credit transactions that are kept current.'"

[23] *Id.* at 512.

[24] *See, e.g., Wickham v. United American Bank (In re Property Leasing & Management, Inc.)*, 46 Bankr. 903, 913-14 (Bankr. E.D. Tenn. 1985); *Tidwell v. Merchants & Farmers Bank (In re Dempster)*, 59 Bankr. 453, 459 (Bankr. M.D. Ga. 1984); *Pippin v. John Deere Co. (In re Pippin)*, 46 Bankr. 281, 283-284 (Bankr. W.D. La. 1984); *Rabin v. Equibank (In re Faller)*, 42 Bankr. 593, 594-95 (Bankr. N.D. Ohio 1984); *Schmitt v. Equibank (In re R.A. Beck Builder, Inc.)*, 34 Bankr. 888, 892 (Bankr. W.D. Pa. 1983); *Sanborn v. Bangor Federal Credit Union (In re Sanborn)*, 29 Bankr. 655, 657-58 (Bankr. D. Me. 1983); *Grant v. Blazer Financial Service (In re Head)*, 26 Bankr. 578, 580 (Bankr. M.D. Fla. 1983).

[25] *See, e.g.*, D. Baird & T. Jackson, *Case, Problems and Materials on Bankruptcy*, 317 (1985); 4 Collier on Bankruptcy ¶ 547.38, at 547-125 (15th ed. 1985); P. Murphy, Creditor's Rights in Bankruptcy § 10.15 (Supp. 1985); Anderson, *In re Iowa Premium Service Co.: When is a Debt Incurred Under 547(c)(2) of the Bankruptcy Code*, 17 Creighton L. Rev. 1075 (1984); Ward & Shulman, *In defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 Wash. U.L.Q. 1, 19 (1983).

interest accrued. The United States Court of Appeals for the Eighth Circuit sitting *en banc* accepted this argument in *Iowa Premium Service Co. v. First National Bank of St. Louis (In re Iowa Premium Service Co.)*,[26] but the decision has not been uniformly followed outside the Eighth Circuit and, therefore, must be strictly limited to the facts and stipulations reached in that decision.[27]

Consumer creditors also asserted that avoiding payments made by consumer debtors on long-term installment obligations did not further equality of distribution of the debtor's estate because the additional sums recovered by the trustee were usually sufficient only to offset the administrative expenses associated with recovery.[28] The net result was that the debtor's estate was not enhanced for the benefit of the creditors.[29]

In addition to the proposal to eliminate the forty-five day requirement,[30] numerous other remedies were pro-

[26] 695 F.2d 1109, 1112 (8th Cir. 1982) (en banc). Significantly, the parties stipulated that the bank creditor's demand note was incurred in the ordinary course of the debtor's and creditor's businesses. *Id.* at 11. *See also Lang v. Advance Loan Co. (In re Graves)*, 45 Bankr. 858, 860 (E.D. Cal. 1985). *See also* American Bar Association Committee on Developments in Business Financing, *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 Bus. Law. 1645, 1649 (1980).

[27] *See, e.g., Lingley v. Stuart Shaines, Inc. (In re Acme-Dunham Inc.)*, 50 Bankr. 734, 741 (D. Me. 1985) (obligation to pay interest "arises when the debtor gets a property interest in the consideration exchanged" in loan transaction).

[28] *See* S. Rep. No. 65, *supra* note 9, at 14 ("[T]he administrative expense of these collections, particularly in individual proceedings, results in very little being distributed to creditors."); S. Rep. No. 446, 97th Cong., 2d Sess. 24 (1982) (same).

[29] *See* 1981 *Hearings on Bankruptcy Reform Act, supra* note 2, at 69 ("By definition, ordinary course payments do not involve creditor pressure of a type which is deterred by the preference section."). Broome, *see supra* note 2, at 107 fn. 128.

[30] S. Rep. 445, 98th Cong., 1st Sess. § 211(b) (1983). The explanation for this change was that the 45-day limitation "places undue

posed, debated and reviewed to resolve the perceived unfairness resulting from the strict application of the preference powers of § 547.[31] In 1981 [32], 1982 [33] and 1983 [34] bills were introduced to reinsert the "reasonable cause to believe" requirement as an element of a preferential transfer under § 547(b). Reinsertion of this requirement would have largely eliminated the alleged problems with the application of the preference provisions because most trade creditors, commercial paper issuers, and consumer lenders would not have reasonable cause to believe the debtor was insolvent.[35] Finally, reinserting the "reasonable cause to believe" requirement into § 547(b) would also serve to protect from avoidance payments to creditors

burdens upon creditors who receive payment under business contracts providing for billing cycles greater than 45 days." S. Rep. No. 65, *supra* note 9, at 60.

[31] It was also suggested that section 547(c)(2) be amended to provide that a payment be excepted from avoidance if made shortly after the date the debt was due.

[32] S. Rep. No. 2000, 97th Cong., 1st Sess. § 10 (1981); H.R. 4786, 97th Cong., 1st Sess. § 11 (1981).

[33] S. Rep. No. 2000, 97th Cong., 2d Sess. § 11 (1982).

[34] H.R. 1800, 98th Cong., 1st Sess. § 111 (1983); S. Rep. No. 445, 98th Cong., 1st Sess. § 211(a) (1983); H.R. 1169, 98th Cong., 1st Sess. § 11 (1983); H.R. 1085, 98th Cong., 1st Sess. § 11 (1983).

[35] The 1898 Act did not draw a distinction between the avoidability of preferential payments on short-term debt and the avoidability of preferential payments on long-term debt, although as a general matter payments on short-term debt were less likely to be found avoidable. In most cases a timely payment on short-term debt, such as trade credit, was not avoidable because a trade creditor was unlikely to have reasonable cause to believe that the debtor was insolvent. See Dunham & Price, *The End of Preference Liability for Unsecured Creditors: New Section 547(c)(2) of the Bankruptcy Code*, 60 Ind. L.J. 487, 493 (1985). Trade credit is short-term credit extended by a seller in connection with the sale of goods or the provision of services. *See* Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, at 769 (1985). Broome, *see supra* note 2, at 107, fn. 134.

on long-term debt, made after the expiration of the protected forty-five day period, if the trustee was unable to prove that the creditor had reasonable cause to believe the debtor was insolvent at the time of the payment.[36]

As a result of pressure asserted by lobbying groups upon Congress with respect to issuers of short-term commercial paper, Congress considered the adoption of changes to § 547(c)(2) which would protect commercial paper purchasers from application of the trustee's avoidance powers.[37] A special exception for payments made by a commercial paper issuer to the purchaser was proposed.[38] The National Bankruptcy Conference objected to this "piecemeal" approach to the problems created by the 1978 Code's radical revision of the preference provision.[39]

The third proposal addressed the problems expressed by consumer installment lenders. It proposed an exception that would insulate a payment from preferential avoidance if the aggregate value of all property constituting or affected by such transfer was less than $250 in a Chapter 7 or Chapter 13 case or less the $750 in a Chapter 11 case.[40] A modified version of this proposal, the current § 547(c)(7), was contained in H.R. 5174, the bill that was eventually passed as the 1984 Amendments.[41]

The culmination of the discussions regarding possible modification of § 547, as it was enacted in the 1978 Code,

[36] *See Farmers Bank v. Julian*, 383 F.2d 314, 326 (8th Cir. 1967). Broome, *see supra* note 2, at 108, fn. 135.

[37] H.R. 5148, 98th Cong., 2d Sess. (1984); S. 445, 98th Cong., 1st Sess. (1983); S. Rep. No. 3023, 96th Cong., 2d Sess. (1980).

[38] H.R. 5148, 98th Cong., 2d Sess. (1984).

[39] *1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 250.

[40] H.R. 1147, 98th Cong., 1st Sess. § 9 (1983).

[41] Cyr, *Setting the Record Straight for a Comprehensive Revision of the Bankruptcy Act of 1898*, 49 Am. Bankr. L.J. 99, 166 n.242 (1975).

was H.R. 5174.[42] H.R. 5174 proposed only one change to § 547(c): the introduction of § 547(c)(7), relating to payments by consumer debtors.[43] The bill was hastily considered in the House because of the urgency of the jurisdictional crisis facing the bankruptcy court system [44] and was passed by the House after the jurisdictional provisions of the bill were amended.[45]

The Senate then began consideration of the bill. Senator Thurmond introduced an amendment in the nature of a substitute for the bill passed in the House.[46] Senator Thurmond noted that although portions of his amendment were not included in the House bill, the changes did "have broad support in the Senate." [47] The amendment contained four distinct provisions affecting the preference provision of the 1978 Code and addressing problems with its operation that had previously been considered by the House and Senate. First, Senator Thurmond proposed to amend § 547(b) to reinsert the "reasonable cause to believe" requirement as an element of a preferential transfer.[48] This proposal was withdrawn by Senator Thurmond prior to the amendment's passage in the Senate,[49] however, apparently in order to gain Senator Metzenbaum's support for the remainder of Senator Thurmond's proposals.[50]

[42] H.R. 5174, 98th Cong., 2d Sess. (1984).

[43] *Id.*

[44] *See supra* note 3. The procedural posture of the bill prevented consideration of more than one amendment, 130 Cong. Rec. H1796 (daily ed. Mar. 21, 1984), although this limitation was controversial.

[45] *Id.* at H1854.

[46] *Id.* at S6081 (daily ed. May 21, 1984). The text of the amendment (No. 3083) is set forth *id.* at S6107-27.

[47] *Id.*, at S6083. Broome, *see supra* note 2, at 109, fn. 146.

[48] *Id.* at S6122. This suggestion had been previously considered in Congress. *See supra* notes 32-34 and accompanying text. Broome, *see supra* note 2, at 110, fn. 147.

[49] *Id.* at S7617 (daily ed. June 19, 1984).

The second proposed change to § 547 involved amending § 547(c)(2) to remove the forty-five day requirement.[51] This change had previously been endorsed by the Senate when it passed S. Rep. No. 445 in 1983.[52] The Senate Report accompanying that bill explained that the change was necessary because the forty-five day limitation "places undue burdens upon creditors who receive payment under business contracts providing for billing cycles greater than 45 days.[53]

A third proposal involved adding § 547(c)(8) to protect payments to commercial paper purchasers from avoidance,[54] but this proposal was also withdrawn prior to the amendment's passage.[55] One possible explanation for the withdrawal of proposed § 547(c)(8) is that elimination of the forty-five day provision from § 547(c)(2) resolved the commercial paper problem and made a special section

[50] *Id.* (statement of Sen. Thurmond).

[51] *Id.* at S6122 (daily ed. May 21, 1984)..

[52] *Id.* at S5388 (daily ed. Apr. 27, 1983).

[53] S. Rep. No. 65, *supra* note 9, at 60. Broome, *see supra* note 2, at 110, fn. 152.

[54] Senator Thurmond's amendment added a new subparagraph (8), under which the trustee could not avoid a transfer to or for the benefit of a creditor to the extent such transfer was made to such creditor by a credit guarantor in payment of a debt evidenced by a note or bond issued by the debtor prior to the commencement of the case and in accordance with the terms of the debtor's credit guaranty agreement with the credit guarantor, and payment of which was supported from time of its issuance until such transfer by an irrevocable letter of credit, irrevocable commitment to lend funds, irrevocable note purchase agreement, or a bond of indemnity issued by a credit guarantor in the ordinary course of its business. *Id.* at S6127 (daily ed. May 21, 1984).

[55] *See* Countryman, *supra* note 35, at 772. Broome, *see supra* note 2, at 110, fn. 154.

protecting payments to commercial paper purchasers unnecessary.[56] However, it is clear that the Senate debate surrounding the issue of commercial paper focused on short-term commercial obligations and not long-term debt.

The final section of Senator Thurmond's amendment affecting § 547(c) was the addition of § 547(c)(7) to protect certain payments be consumer debtors from preferential avoidance.[57] The proposed addition was identical to that already approved in the House version of H.R. 5174. The Senate passed H.R. 5174,[58] as changed by Senator Thurmond's amendment, adding § 547(c)(7) to the 1978 Code to protect some payments by consumer debtors from avoidance and eliminating the forty-five day provision from § 547(c)(2).

The Senate insisted on its version of the bill and asked for a conference with the House.[59] The House agreed to the conference and the conference report was submitted on June 29, 1984.[60] The report did not include a joint explanatory statement of the bill, but only the text of the

[56] A discussion on the Senate floor between Senators Dole and DeConcini regarding the Conference Report on the bill indicates that they believed that the elimination of the 45-day requirement would "relieve buyers of commercial paper with maturities in excess of 45 days of the concern that repayments of such paper at maturity might be considered as preferential transfers," and that "companies that have a need for short-term funds, and investors who wish to purchase short-term obligations, would both be acting in their respective 'ordinary course of business or financial affairs'" in dealing with each other in the commercial paper market. 130 Cong. Rec. S8897 (daily ed. June 29, 1984, pt. II). *See also* Dunham & Price, *supra* note 35, at 497-99. Broome, *see supra* note 2, at 110, fn. 155.

[57] 130 Cong. Rec. S6114 (daily ed. May 21, 1984).

[58] *Id.* at S7625 (daily ed. June 19, 1984).

[59] *Id.*

[60] H.R. Conf. Rep. No. 882, 98th Cong., 2d Sess., *reprinted in* 1984 U.S. Code Cong. & Admin. News 576.

bill as agreed to in conference. The conference version of the bill was identical to the version passed by the Senate as it related to § 547.[61] The conference bill was accepted by both the Senate and the House[62] and signed by the President.

The end result of all bills, discussions, decisions and debates was the final changes made by the 1984 Amendments to the preference provision which Respondent asserts were made merely in response to particular concerns of various creditor groups. Removal of the forty-five day provision responded to problems encountered by trade creditors[63] and commercial paper purchasers[64] who asserted that the arbitrary forty-five day limitation was not consistent with regular short-term extensions of credit and resulted in the distortion of normal business practices to fit within the exception. Further, the addition of § 547(c)(7) to protect certain small dollar amount transfers by consumer debtors responded to the problems encountered by lenders to consumers following elimination of the "reasonable cause to believe" requirement.[65]

It is the position of the Petitioner that removal of the forty-five day provision from the ordinary course of business exception should be read as extending the preference powers exception's protection to payments on long-term debt because the legislative history contains no express statement which limits § 547(c)(2) to short-term debt [Petitioner's Brief at p. 10]. One commentator has agreed

[61] 130 Cong. Rec. S8887 (daily ed June 29, 1984, pt. II) (statement of Sen. Thurmond); *id.* at H7489 (daily ed. June 29, 1984, pt. I) (statement of Rep. Rodino).

[62] *Id.* at S8900, H7500 (daily ed. June 29, 1984, pt. II).

[63] *See supra* text accompanying notes 7-15

[64] *See supra* text accompanying notes 16-20.

[65] *See supra* text accompanying notes 21-25. Broome, *see supra* note 2, at 111, fn. 164.

with this position.[66] However, Respondent urges this Court to recognize that a contrary inference seems more persuasive—that is, the absence of any clear indication that Congress intended to expand § 547(c)(2) protection to long-term debt justifies an inference that there was *no* such intent. Furthermore, because *no* creditors complained during the hearings conducted on the operation of the 1978 Code that the avoidance of payments on long-term debt by business debtors was unfair,[67] it is unlikely that Congress considered the avoidability of such payments a problem that it should address. Nor is there any indication that Congress intended, by eliminating the forty-five day requirement, to narrow the chief objective of the preference provision from that of preserving equality of distribution to that of preventing inequality resulting from impermissible creditor pressure applied by a creditor hoping to obtain more favorable treatment than it would otherwise receive in the debtor's bankruptcy proceeding. The most obvious indication that Congress did not wish to return to a concept of avoiding only those payments that might be the result of creditor pressures was its decision not to return to the "reasonable cause to believe" requirement as an element of a preferential transfer. Long-term creditors lost the protection of the "reasonable cause to believe" requirement as a result of a deliberate policy choice by Congress in the 1978 Code. It appears unreasonable to suggest that Congress intended to overturn that choice in the 1984 Amendments without significant discussion,[68] particularly when the discussion

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[66] DeSimone, *Section 547(c)(2) of the Bankruptcy Code: The Ordinary Course of Business Exception Without the 45-Day Rule*, 20 Akron L. Rev. 95, 129 (1986).

[67] *See supra* note 6 and accompanying text. Broome, *see supra* note 2, at 112, fn. 166.

[68] *See Aguillard v. Bank of Lafayette (In re Bourgeois)*, 58 Bankr. 657, 659-60 (Bankr. W.D. La. 1986). Broome, *see supra* note 2, at 112, fn. 167.

that did accompany the amendment of § 547(c)(2) is consistent with interpreting the section to protect only short-term debt.

While Petitioner may attempt to persuade this Court that a different conclusion is warranted, Petitioner's "call to arms" must fall upon deaf ears since Petitioner can point to *no* Congressional history which demonstrates that Congress intended a radical departure from the general principles of preference law enacted under the 1978 Code. More importantly, the Congressional confusion over which changes to make to the 1978 Code, coupled with the fact that most desired changes did not become part of the 1984 Amendments only serves to further support the position urged by Respondent; Congressional Amendments to § 547 (c) under the 1984 Act were not intended to protect payments on long-term debt obligations from a trustee's preference avoiding powers. If the primary goal intended by Congress in its enactment of § 547 under the 1978 Code was to insure equality of distribution amongst the creditors of a bankrupt's estate then, the spirit and quality of these preference powers granted a trustee can only be meaningful if not emasculated by exceptions to the rule. A determination by this Court that Congressional changes to § 547(c) under the 1984 Amendment were primarily concerned with short-term credit facilities and the protection of persons receiving payments in consideration of such short-term credit extensions would serve to protect and preserve the preference powers vested by Congress in a trustee. Enlarging the exception to include payments on long-term debt would only defeat the primary objective: Equality of Distribution.

II. PROTECTING PREFERENCE PAYMENTS MADE BY A DEBTOR ON ACCOUNT OF A LONG-TERM DEBT OBLIGATION DOES NOT FURTHER THE POLICY UNDERLYING THE RECOVERY OF PREFERENCES.

The legislative history of the ordinary course of business exception supports Respondent's interpretation and that of the Seventh, Ninth and Eleventh Circuit Courts of Appeals that § 547(c)(2) excludes long-term debt from its coverage. The policies of the preference provision and the ordinary course of business exception supports Respondent's position that the exceptions were intended to be limited and narrowly construed.

The principal objective of the preference provision is to "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor." [69] When a debtor becomes insolvent, a transfer to a creditor whose claim is not fully secured necessarily impairs the claims of the debtor's other unsecured and undersecured creditors.[70] The trustee's power to avoid preferential transfers only partially prevents the resulting unequal treatment of creditors because the power in most cases extends only to transfers made during the ninety day period preceding the filing of the bankruptcy petition and does not reach transfers previously made by an insolvent debtor.[71]

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[69] H.R. Rep. No. 595, 95th Cong., 1st Sess. 178 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 Va. L. Rev. 249, 260 (1981). *See also Yellowhouse Machinery Co. v. Mack*, 704 F.2d 820, 822 (5th Cir. 1983) in which the Fifth Circuit Court of Appeals stated: "The nature of the different avoiding powers guaranteed by Section 547 . . . is intended to promote the common good of *all* of an estate's creditors by fostering 'the *prime* bankruptcy policy of equality of distribution among creditors of the debtor'." (Emphasis added)

[70] *See* McCoid, *supra* note 69, at 260.

[71] The trustee is empowered only to avoid preferential transfers made 90 or fewer days before the filing of the bankruptcy petition, § 547(b)(4)(A) (Supp. III 1985), or less than one year before the filing of the petition if the transfer is to an insider. *Id.* § 547(b)(4)(B). Broome, *see supra* note 2, at 113, fn. 170.

It has been suggested that § 547(c)(2), as originally enacted, was justified because it was not inconsistent with the goal of equal distribution. The argument is that payments of short-term debt do not deplete the debtor's estate because the recent extension of credit provides offsetting value to the estate.[72] The court in *Bourgeois* and at least one commentator have relied on this "depletion of the estate" rationale to argue that § 547(c)(2), as amended, should not be read to cover payments on long-term debt.[73] If the transfer of a payment is a preference, the payment, by definition, diminishes the estate that would otherwise be available for all creditors pursuant to § 547(b)(5).[74] This, however, has no bearing upon the true goal: equality of distribution. The equality of distribution goal, however, distinguishes between creditors and noncreditors.[75] Creditors are not treated unequally when a debtor transfers assets in an exchange with a

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[72] *See Lingley v. Stuart Shaines, Inc. (In re Acme-Dunham Inc.)*, 50 Bankr. 734, 740 (D. Me. 1985); Herbert, *The Trustee Versus the Trade Creditor II: The 1984 Amendment to Section 547(c)(2) of the Bankruptcy Code*, 2 Bankr. Dev. J. 201, at 217 (1985); Kaye, *Preferences Under the New Bankruptcy Code*, 54 Am. Bankr. L.J. 197 (1980).

[73] *See Aguillard v. Bank of Lafayette (In re Bourgeois)*, 58 Bankr. 657, 660 (Bankr. W.D. La. 1986).

[74] 11 U.S.C. § 547(b)(5) (1982) setse forth as an element of a preferential transfer the requirement that as a result of the transfer the transferee receive more than it would have received in a Chapter 7 proceeding if the transfer had not been made. Thus, "any transfer to a creditor within the 90-day period by way of payment on or security for an antecedent debt causes a depletion of the debtor's estate and, other elements being present, will constitute a voidable preference." 4 Collier on Bankruptcy ¶ 547.20, at 547-83 (15th ed. 1985).

[75] Broome, *see supra* note 2, at 114, fn. 174.

noncreditor. For example, a merchant who sells goods for cash [76] rather than for a claim to a future transfer does not share the risk that the debtor may have insufficient assets to satisfy future claims. In contrast, a creditor shoulders the risk of nonpayment equally with other creditors.

A second objective of the preference provision is to assist the debtor in working its way "out of a difficult financial situation through cooperation with all of his creditors" by discouraging creditors from engaging in the so-called "race ofdiligence." [77] The House and Senate Reports accompanying the 1978 Code reiterate that § 547 (c) (2) was designed to "leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section [which is] to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." [78]

It has also been suggested that § 547(c)(2) should be extended to protect payments on long-term debt because (1) the long-term creditor is not likely to take part in a race to gain advantage over other creditors, and (2) regular payments on long-term debt constitute normal financial relations that should not be disturbed.[79] This assertion, however, is strained for four reasons. First,

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[76] A transfer cannot be on account of an antecedent debt if it is made for new value. "New value" is defined to include "money or money's worth in goods." 11 U.S.C. § 547(a)(2) (Supp. III 1985). Of course, the exchange must not be so unequal as to amount to a fraudulent conveyance. *Id.* § 548 (1982 & Supp. III 1985).

[77] H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138.

[78] H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6329; S. Rep. No. 989, 95th Cong., 2d Sess. 88, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5874. Broome, *see supra* note 2, at 115, fn. 179.

[79] *See supra* note 66 and accompanying text. Broome, *see supra* note 2, at 115, fn. 180.

the legislative history is misleading. After Congress removed the "reasonable cause to believe" requirement in 1978, the main goal of the preference provision was to preserve equality of distribution; the prevention of unusual pressure or action by the creditor became only an incidental objective.[80] Second, and more importantly, there is *no* direct indication that Congress intended to change this policy focus in the 1984 Amendments.[81] Congress rejected returning to the goal of preventing unusual action by declining to reinsert the "reasonable cause to believe" requirement.[82] The elimination of that requirement was one of the most significant and debated changes to the preference provision made by the 1978 Code.[83] It seems unlikely that removal of the forty-five day requirement from § 547(c)(2) was intended to change the focus of the preference provision from equality of distribution to prevention of the race of diligence, especially in the absence of any discussion to that effect.[84]

Third, commentators argue that § 547(c)(2), as amended, protects payments on long-term debt because these payments are within normal financial relations.[85] These commentators rely on the legislative history accompanying the 1978 version of § 547(c)(2).[86] This reli-

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[80] H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138.

[81] *See supra* text accompanying note 66.

[82] *See supra* text accompanying notes 32-34, 147-48. Broome, *see supra* note 2, at 116, fn. 183.

[83] *See* D. Baird & T. Jackson, *supra* note 25 at 284. Broome, *see supra* note 2, at 116, fn. 184.

[84] *See supra* note 68. Broome, *see supra* note 2, at 116, fn. 185.

[85] *See supra* note 25. Broome, *see supra* note 2, at 116, fn. 186.

[86] See H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* 1978 U.S. Cong. & Admin. News 5963, 6329; S. Rep. No. 989, 95th Cong., 2d Sess. 88, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5874. Broome, *see supra* note 2, at 116, fn. 187.

ance on the "normal financial relations" concept is misplaced, however, because this phrase refers to payments on debt satisfying the ordinary course of business requirements and made within forty-five days of the date the debt was incurred. Unlike short-term debt, long-term debt is generally not incurred in the "ordinary" course of business, but rather, represents an extraordinary transaction providing for extensive capital funding of a debtor's business operation. Since the statutory provision was specifically limited to short-term debt, it cannot be said that Congress intended "normal financial relations" to encompass payments made on account of an antecedent long-term debt.

Finally, declining to read § 547(c)(2) as extending to payments on long-term debt does not imply a complete rejection of the deterrence objective. Although deterring the race to dismember the debtor is not the major objective of the preference provision, deterrence is recognized in current §§ 547(c)(2)(B) and (C), which require that payments be made (1) in the ordinary course of business of the debtor and the transferee and (2) according to ordinary business terms.[87] A payment compelled by creditor pressure would not be afforded protection from avoidance.

If the ordinary course of business exception is inconsistent with the goal of equality, and if the protection of "normal financial relations" does not define the outer limits of the exception as amended in 1984, the problem of defining the outer limits of the exception remains. The resolution of this problem relates to the reasons behind preventing the race of diligence.[88] Congress intended to deter the race of diligence in order to enable the debtor "to work his way out of a difficult financial situation

[87] 11 U.S.C. § 547(c)(2)(B), (B), (C) (Supp. III 1985). Broome, *see supra* note 2, at 116, fn. 188.

[88] Broome, *see supra* note 2, at 1169.

through cooperation with all of his creditors."[89] This statement indicates that Congress intended to encourage[90] ordinary transactions that may keep the debtor in business.[91] This goal suggests a way to distinguish between debt incurred in the ordinary course of the debtor's business and debt that is not so incurred.[92]

Section 547(c)(2) encourages creditors to extend short-term credit to finance a troubled debtor's current operations. In most instances, a creditor's decision to lend money to a debtor depends on whether the creditor believes the debtor will be able to repay the loan when due and whether the creditor believes the debtor will not enter a bankruptcy proceeding for ninety days thereafter. A short-term creditor evaluating the risk of nonpayment might be fairly confident that the debtor will be able to repay the debt when due from the proceeds of the current operations financed by the debt. On the other hand, a long-term debt lender will normally expect to receive repayment of the obligation owed by a debtor out of the long-term profits generated by a debtor out of its continued business operation. For instance, a creditor extending credit to finance the debtor's purchase of raw materials may view the proceeds arising from later sales of the finished goods as the source of funds to repay the loan. If the short-term creditor believes that the risk of nonpayment is minimal, it must still evaluate the likelihood that the debtor will enter a bankruptcy proceeding

[89] H.R. Rep No. 595, 95th Cong., 1st Sess. 177 1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138.

[90] *See*, Herbert, *supra* note 13, at 670 & n.14. Broome, *see supra* note 2, at 117.

[91] *See* Morrow v. United States (*In re* Morris), 53 Bankr. 190, 192 (Bankr. D. Or. 1985) ("This court believes that the purpose of § 547(c)(2) was to encourage creditors to continue short-term credit dealings with troubled debtors in order to forestall bankruptcy rather than encourage it.").

[92] Broome, *see supra* note 2, at 117.

within ninety days after the payment. If the ordinary course of business exception is not available, then a debtor (especially one experiencing temporary financial difficulty) might be unable to borrow to finance its current operations. In contrast, the extension of § 547(c)(2) to cover payments on long-term debt does not significantly affect the long-term creditor's initial decision to make a loan. For example, suppose the creditor contemplates a one-year loan to be repaid in monthly installments. Interpreting § 547(c)(2) to extend to payments on long-term debt only affords protection for ninety days of payments received at the end of a twelve month payback period. Protecting these payments from avoidance will not significantly alter the creditor's risk of the debtor's insolvency, and thus offers little inducement to a creditor to extend long-term debt.[93]

In addition, preserving the trustee's ability to avoid payments to a long-term creditor may further the goal of preventing the debtor's bankruptcy.[94] Suppose a debtor is unable to meet all of its financial obligations, including a regularly scheduled payment to a long-term creditor, and asks the long-term creditor for an extension so that it may meet its obligations to suppliers with whom it must deal to continue its operations. If § 547(c)(2) protects any regular payment received by the long-term creditor from avoidance, the creditor may insist on its regular payment knowing that it will not be avoidable if the debtor enters bankruptcy within the following ninety days. If § 547(c)(2) does not protect regular payments on long-term debt from avoidance, the creditor has an incentive to work with the debtor so that the debtor may overcome its temporary financial difficulties, stay out of bankruptcy, and eventually meet all of its obligations in full.

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[93] Broome, *see supra* note 2, at 117.

[94] *See supra* notes 90-92 and accompanying text. Broome, *see supra* note 2, at 118 fn. 192.

Thus, the goal of encouraging creditors to deal with the debtor suggests a way to distinguish between debt incurred in the ordinary course of the debtor's business and debt that is not so incurred.[95] This distinction, as suggested above, may depend on whether the debt is short-term or long-term because the extension of short-term credit is necessary for the continuing operations of the debtor. Even if it is possible to distinguish between short-term and long-term debt, Respondent argues that § 547(c)(2) should be read even more narrowly to include only trade credit.[96]

The legislative history of the ordinary course of business exception indicates that Congress intended the exception to comprehend payments to trade creditors.[97] There are also indications that Congress assumed that short-term commercial paper could be issued in the ordinary course of a debtor's business. Congress conducted hearings on problems experienced by commercial paper issuers under the 1978 Code.[98] The focus of the discussion was *not* whether commercial paper could be issued in the ordinary course of a debtor's business, but whether the maturities of commercial paper issues had been artificially limited by § 547(c)(2) to less than forty-five days.[99] Moreover, when the forty-five day provision was removed in 1984, Senators Dole and DeConcini asserted that "companies that have a need for *short-term funds*,

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[95] *See* Countryman, *supra* note 35, at 775-75. Broome, *see supra* note 2, at 118, fn. 193.

[96] *See Aguillard v. Bank of Lafayette* (*In re* Bourgeois), 58 Bankr. 567, 660 (Bankr. W.D. La. 1986) (suggesting that section 547(c)(2) "was intended to apply to trade credit transactions" rather than long-term debt).

[97] *See supra* text accompanying note 7.

[98] *See supra* text accompanying notes 16-18. Broome, *see supra* note 2, at 121, fn. 203.

[99] *See supra* note 19 and accompanying text.

and investors who wish to purchase *short-term obligations*, would both be acting in their respective 'ordinary course of business or financial affairs' if they were to deal directly or indirectly with each other in the commercial paper market." [100] Respondent asserts that short-term debt and not long-term debt from banks or other financial institutions is the focus of attention and protection as can be gleaned from all discussions pertaining to the 1984 Amendments.

Congressional changes made to § 547(c)(2) all focused on the need of a debtor to obtain *short-term* credit to allow it to operate its busines during difficult times. To protect persons who continued to assist the debtor through difficult times by extending *short-term* credit to it, Congress eliminated an artificial 45-day rule and established a facts and circumstance test. However, Congress did *not* deviate from its original goal of preference avoiding powers; the equality of distribution amongst creditors. Surely, Congress did not intend a lender who receives a payment on a long-term debt to benefit more than an unpaid short-term creditor who was not so lucky to receive a payment prior to the debtor's slide into bankruptcy. Of course it did *not*! The only method to promote equality of distribution amongst unsecured creditors is to require disgorgement of preference payments on long-term debts received within 90 days of the debtor's filing of its bankruptcy petition.

More importantly, an anomaly would surely result if a long-term lender received a repayment of the principal amount of its obligation during the 90-day period prior to the debtor's filing for bankruptcy and the short-term creditor received nothing. Can Petitioner seriously argue that the repayment of the principal balance of a long-term loan is likewise excepted from the trustee's avoiding powers through the application of § 547(c)(2)? Re-

[100] 130 Cong. Rec. S8897 (daily ed. June 29, 1984, pt. II) (statement of Sen. DeConcini) (emphasis added). See supra note 56.

spondent thinks not. Equality of distribution means equality amongst creditors. This is best accomplished by narrowing the exceptions to a preference recovery and not by further expansion. Respondent opines that protecting preference payments made by a debtor on a long-term debt obligation does not further the first and foremost policy goal underlying the recovery of preferences: Equality of Distribution.

III. THE *ZBEST* DECISION IS IN CONFORMITY WITH THE LEGISLATIVE AND JUDICIAL HISTORY OF THE PREFERENCE STATUTE.

Petitioner, Union Bank, argues that the decision of the Ninth Circuit does not comport to the clear and plain language of the statute. Petitioner's Brief at p. 11. Petitioner bases this argument upon amendments made to the statute in 1984 pursuant to which the 45-day limitation was deleted. The decision of the Ninth Circuit is *not* contrary to the legislative policy and judicial interpretation of the statute enacted under the 1978 Code. Other circuit courts which have ruled upon the applicability of § 547(c)(2) to protect preferential payments, as most notable *Marathon Oil Co. v. Flatau (In re Craig Oil Co.)*, 785 F.2d 1563 (11th Cir. 1986), have reached the same conclusions as those reached by the Ninth Circuit. Specifically, in the Eleventh Circuit Court of Appeals decision, a "trade" creditor sought to avoid attack by the Chapter 11 trustee to recover payments made by a debtor as a preference under the provisions of § 547(b). As the Eleventh Circuit noted at page 1567:

> "As several courts have noted, this exception is directed primarily to ordinary trade credit transactions. These typically involve some extension of credit that are meant to be paid in full within a single billing cycle . . . Because the credit extended is meant to be extremely short term, Congress likened payment of trade credit to payment of current expenses. Recognizing that the latter had tradition-

> ally been protected from avoidance in bankruptcy, Congress insisted on the same protection to trade credit through the ordinary course of business provision . . . Since the foundation of this provision is the similarity of trade credit and current expense rule, the scope of its protection is necessarily limited to trade credit which is 'kept current' or other transactions which are paid in full within the initial billing cycle." [101]

It is interesting to note that the Eleventh Circuit in the *Marathon* decision cites the Seventh Circuit decision of *Barash v. Public Finance Corp., supra*, which coincides with the jurisdiction presiding over the *Levit v. Ingersol Rand Financial Corp.* 824 F.2d 1186 (7th Cir. 1986) [hereinafter referred to as "*Deprizio*"] decision cited in Petitioner's Brief at p. 4. In *Deprizio*, the Seventh Circuit did not overrule the *Barash* decision, nor was that decision ever discussed. More importantly, the *Deprizio* court, at page 1199 specifically stated that:

> "We need not decide whether installment payments before 1984 may be recovered even though made within forty-five days of their due date, because this appeal does not present for decision the trustee's effort to recoup any particular transfer. It is enough to observe that § 547(b)(5) and (c), both *before and after amendment* exclude from recovery the bulk of ordinary commercial payments." [Emphasis Added]

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[101] As the Eleventh Circuit pointed out in its decision at Footnote No. 8 at page 1567, 'it was for this reason that Congress originally required payment within forty-five days of incuring the obligation. This period represents a normal trade cycle.' Furthermore, Petitioner notes that there *may* also be a conflict with the Eighth Circuit based upon *Iowa Premium Service Co., Inc., supra* note 26. However, Petitioner's argument is misplaced since the parties thereto *stipulated* to the fact that the ordinary course of business exception applied and that the only issue was the date upon which the debt was incurred. As such, *Iowa Premium Service Co., Inc.* is completely inapplicable to the case at bar.

As pointed out, Respondent urges this Court to note that the Seventh Circuit did not reverse the *Barash* decision which supports the finding by the Ninth Circuit in its *CHG* and *ZBest* opinions, respectively, and more so, that the *Deprizio decision* does not go directly to the merits of the case at bar. More importantly, the *Deprizio court noted* no distinction to the protection provided by § 547(c)(2) prior to and after the 1984 Amendments. As such, the *Deprizio* decision is inappropriate for consideration in the case at bar. More importantly, the Eleventh and Seventh Circuit decisions in *Marathon* and *Barash*, respectively, supports the holding by the Ninth Circuit in *ZBest*.

What the Seventh Circuit, Ninth Circuit and Eleventh Circuits, respectively, have recognized is that the scope and purpose of § 547(c)(2) was not changed by the mere deletion of a forty-five day artificial rule but instead, attention must be focused upon the value derived by a debtor in exchange for the payments being made and fostering the primary goal of equality of distribution. It is, of course, this presumption that enables short-term trade creditors to avoid attack by a trustee seeking to recover alleged preference payments when the value received by the debtor in exchange for the payments have allowed the debtor to continue to operate its business. In the case at bar, the funds were drawn down by *ZBest* over seven months prior to its filing for protection from creditors. The continued payments of interest did not serve to enhance the business of ZBest but merely prolonged the fraudulent business enterprise by taking under its umbrella additional victims.

IV. WHERE THE STATUTE IS UNCLEAR ON ITS FACE, THE INTENTION OF THE DRAFTERS SHOULD GOVERN.

In *United States v. Ron Pair Enterprises, Inc.* 489 U.S. 235 (1989), this Court found the statutory language of § 506(b) to be clear on its face and, therefore, this Court enforced said provisions according to its terms. Nevertheless, this Court was quick to note, at 1031, that:

> "The plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters . . . In such cases, the intention of the drafters, rather than the strict language, controls." (Citations omitted.)

The case at bar is not only one of those "rare" cases but more importantly, it is of exceptional importance to the bankruptcy bar. Petitioner would have this Court believe that the amendments to § 547(c)(2) in 1984, evidenced a Congressional intent to include long-term debt within the statutory exceptions to a trustee's avoiding power. However, this Congressional intent is far from clear.[102] As suggested by one leading commentator, the best future

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[102] In *WJM, Inc. v. Massachusetts Dept. of Public Welfare* 840 F.2d 996, 1010 (1st Cir. 1988), the First Circuit Court of Appeals noted that "several Bankruptcy Courts have lamented Congress' failure to flesh out its concept of the 'ordinary' under this section." The First Circuit cited *In re Magic Circle Energy Corp.*, 64 Bankr. 269, 272 (Bkrtcy. W.D. Okl. 1986) for this latter proposition. However, it is worth noting the *Magic Circle* court, at 273, quite clearly stated its recognition that § 547(c)(2) excludes from its protection payments on long-term debt by stating that "while we can concur in the proposition that *there exists a distinction between a long-term loan and an ordinary credit transaction*, we do not believe that such dissimilitude is pertinent to the matter at bar." [Emphasis Added.] Respondent opines that given the First Circuit's adoption of the *Magic Circle* decision that it would likewise concur with the finding that § 547(c)(2) is not applicable to payments made on account of long-term debts.

for § 547(c)(2) is repeal due to the absence of "rational confining limits." [103] Unless legislative intent is clearly demonstrated to *repeal* the substance of preference powers on long-term debt, this Court should be slow to reverse a long-standing rule absent clear and convincing evidence of such an intent.[104]

The judicial interpretation by the Seventh, Ninth and Eleventh Circuits maintains the integrity of the preference powers and is reasonable and consistent with respect to long-term debt. The preferential payments made by ZBest to Petitioner did *not* provide any current benefit (value) to ZBest at the time they were made. There was merely a depletion of ZBest's estate. The proper remedy for depletion is restoration—this is best accomplished by the implementation and utilization of the preference powers to further the goal of Equality of Distribution.

V. THE HOLDING BY THE NINTH CIRCUIT ENFORCES A LONG-STANDING POLICY THAT PAYMENTS ON LONG-TERM OBLIGATIONS SERVE NO BENEFIT TO THE DEBTOR AND MUST BE AVOIDED.

Petitioner points out in its Brief that two policies underlie the preference law, those being:

1. To discourage a "race to the courthouse;" and

2. Dismemberment of the debtor during the debtor's financial decline and to equalize the distribution of assets of the estate among similarly situated creditors.

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[103] Countryman, *supra* note 35, at 769.

[104] The Sixth Circuit in *Gosch v. Burns (In re Finn)*, 909 F.2d 903 (6th Cir. 1990) discusses *Ragsdale v. Citizens and Southern National Bank (In re Control Electric, Inc.)*, 91 Bankr. 1010 (Bankr. N.D.Ga. 1988) and disagreed with the general proposition that without legislative history to back it up, a change in the language of the statute is not to be respected. See also, *Waldschmidt v. Ranier (In re Fulghum Construction Corp.)* 872 F.2d 739 (6th Cir. 1989), wherein 547(c)(2) protection was made available to repayments of "short-term" cash advances.

However, Petitioner's argument falls short of demonstrating why its financial arrangement with ZBest and the preferential payments it received merit consideration as being outside the scope of these two policies. Of greater importance is the fact that Petitioner weakly discusses the most important goal of the preference avoiding powers: Equality of Distribution.

Specifically, the transaction between Union Bank and ZBest did not represent a "normally reoccurring transaction" since the $7 million loan by Union Bank to ZBest vastly exceeded any other normal credit transaction which ZBest had entered into. This large loan was utilized to enhance and in furtherance of the ZBest fraudulent business enterprise.

While Petitioner may argue that its loan should be aligned with a sale of commercial paper, it is worth noting that the seller of short-term commercial paper (a financial institution or public corporation) is making a sale of inventory or short-term notes to assist it in the ordinary course of its business. It is obvious that it was the debtor/seller of commercial paper that sought protection since if it was unable to sell its inventory/notes, its slide into bankruptcy would be accomplished at a much quicker pace. Furthermore, extending protection to purchasers of short-term commercial paper provides assurances to such purchasers that continued business dealings with a financially troubled debtor will not result in adverse financial consequences upon the receipt of repayment. Through the redemption of commercial paper a debtor is once again able to reenter the money market and obtain additional short-term capital infusions for its continued business operation.[105]

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[105] The Tenth Circuit decision in *Fidelity Savings & Investment Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989) clearly demonstrates these considerations by the Senate in discussing commercial paper redemptions. Additionally, see *CHG International*, *supra*, in which, at fn. 11, the Ninth Circuit determined the *Fidelity* opinion to be weak, and noted that the *Fidelity* court expressly refused to decide whether it agreed with cases that hold that long-term loans are excepted from treatment as a preference. *See also supra* note 10.

More importantly, the Tenth Circuit Court of Appeals in *Johnson v. Barnhill* (*In re Antweil*) 931 F.2d 689 (10th Cir. 1991) recently discussed the scope, purpose and intent of the trustee's preference avoiding powers. While the specific facts of the *Johnson* decision concerned the determination of the date upon which a "transfer" occurs for purposes of § 547(b), the Tenth Circuit provided insight as to the limited scope and applicability of § 547(c)(2). The Tenth Circuit noted that:

> "The most important purpose of § 547(b) is to facilitate equal distribution of the debtor's assets among the creditors . . . To accomplish this purpose, Congress has created an arbitrary time period consisting of the 90 days immediately preceding the filing of the bankruptcy petition . . . Creditors who receive payments on pre-existing debts before this time period begins may keep those payments. However, *creditors who receive payments on pre-existing debts within the 90-day period must disgorge those payments so that they may be shared equally with other creditors . . .*" At page 692. [Emphasis Added]

In discussing § 547(c), the Tenth Circuit explained:

> "The purpose of § 547(c) defenses is to encourage trade creditors and other suppliers of goods and services to continue dealing with troubled businesses without fear of the Trustee's avoiding powers." At page 693.[106]

Finally, the Tenth Circuit in discussing § 547(c)(2) stated:

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[106] The *Johnson* decision contains limiting language as to the scope of protection provided by § 547(c)(2) which demonstrates consideration of matters not discussed in the *Fidelity* decision, *supra* note 105.

> ". . . Under this section, a power company, for example, may continue to supply a financially troubled company on condition that the company continue to make regular and timely payments." At page 693.

What becomes readily apparent is that the Tenth Circuit has recognized what the Seventh, Ninth and Eleventh Circuits had already concluded: that § 547(c)(2) is not intended to protect payments made on long-term, pre-existing debt during the 90-day period preceding the bankruptcy filing, but, rather, was intended to protect payments made to persons supplying value to the debtor during said 90-day period.

These facts are diametrically opposed to the facts of the case at bar. Specifically, Union Bank made one (1), segregated loan to ZBest which had a maturation date of over eight and one-half months. The policy discussed by the Senate in modifying the provisions of § 547(c)(2) to accommodate commercial paper sought to normalize the trade credit transactions in selling short-term commercial paper and to eliminate an artificial time limit is not applicable to the base at bar. If Congress had intended to totally emasculate the preference provisions as to payments made on long-term debt obligations, then Congress should have specifically stated that the exception provided by § 547(c)(2) is not limited to normal trade credit transactions but rather, encompasses all transactions between a debtor and *any* creditor. Congress did not so intend and this Court should not so construe a statute which was not specifically modified with the intent of including protection for payments on long-term debt obligations.

VI. THE NINTH CIRCUIT, RELYING ON *CHG INTERNATIONAL, INC.*, PROPERLY DETERMINED THAT PREFERENTIAL PAYMENTS UPON A LONG-TERM DEBT INSTRUMENT ARE OUTSIDE THE SCOPE OF THE PROTECTION AFFORDED BY § 547(c)(2).

In its *CHG International* decision, the Ninth Circuit *correctly* pointed out at page 1483 that § 547(c)(2) "was intended to complement the contemporaneous exchange section." In so finding, the Ninth Circuit relied upon the Seventh Circuit decision in *Barash*, *supra*.[107] Moreover, the Ninth Circuit correctly pointed out that:

> "The rationale for both the old 'current expense' rule and for § 547(c)(2) exception is the same: the payment does not diminish the estate, is not for an antecedent debt, and allows the debtor to remain in business." At 1483.

In the case at bar, the preferential transfers from ZBest to Petitioner, Union Bank:

(1) Diminished the estate;

(2) Were on account of an antecedent debt; and

(3) Did nothing to allow ZBest to remain in business.

Respondent urges this Court to recognize, as did the Ninth Circuit in *CHG International* and ZBest, the Seventh Circuit in *Barash*, the Tenth Circuit in *Johnson* and the Eleventh Circuit in *Marathon*, that the better view is that Congress did *not* intend to fundamentally change the preference avoiding powers but rather, to only eliminate an artificial time limit so as to normalize trade credit transactions on short-term financial arrangements.

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[107] See also *Appeal of California Sunnyvale Associates (In re Xonics Imaging Inc.)*, 837 F.2d 763, 766 (7th Cir. 1988).

VII. THE ORDINARY COURSE OF BUSINESS EXCEPTION IS INAPPLICABLE TO A CREDITOR WHERE THE DEBTOR ENGAGED IN A FRAUDULENT BUSINESS SINCE THERE IS NO ORDINARY COURSE OF BUSINESS BEING CARRIED ON.

As argued in the lower court, but not decided by the Ninth Circuit Court of Appeals in the *ZBest* decision, a line of cases has developed which holds that a debtor who engages in a Ponzi/fraudulent business enterprise cannot be deemed to be operating an ordinary business and, therefore, creditors are unable to rely upon the ordinary course of business exception provided by § 547(c)(2) to avoid a preference attack by a trustee. See *Danning v. Bozek (In re Bullion Reserve of North America)*, 836 F.2d 1214 (9th Cir. 1988); *Graulty v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.)* 819 F.2d 214 (9th Cir. 1987).

While the Ninth Circuit did not reach this issue (as a result of its determination that the obligation owed by ZBest to Union Bank was a long-term debt obligation), if this Court should determine that the arguments of Petitioner have merit, then this Court should consider addressing the subsidiary issue which the Ninth Circuit failed to address. As aptly stated by the Ninth Circuit in *Bullion Reserve* and *Graulty*, respectively, the protection afforded under § 547(c)(2) was not intended to protect one victim of the debtor's fraud at the expense of others. Where a debtor engages in activities which are tantamount to a Ponzi scheme/fraudulent business enterprise, the debtors may not be said to be operating a legitimate trade or business and, therefore, no transaction can be considered "ordinary."

CONCLUSION

WHEREFORE, Respondent, Herbert Wolas, prays that the judgment of the United States Court of Appeals for the Ninth Circuit be affirmed.

Respectfully submitted,

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